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FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF SECRETARY

January 10, 1997

Mr. William F. Caton
Acting Secretary
Federal Communications Commission
1919 M Street, N.W.
Room 222
Washington, D.C. 20554

Re: CC Docket No. 96-45

Dear Mr. Caton:

Transmitted herewith, on behalf of TDS Telecommunications Corporation (TDS Telecom) and Century Telephone Enterprises, Inc. (Century) are an original and 8 copies of their reply comments in response to comments filed December 19, 1996 on the Joint Board's Recommended Decision in the above-referenced proceeding.

In the event of any questions concerning this matter, please communicate with this office.

Very truly yours,

Margot Smiley Humphrey

Margot Smiley-Humphrey

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FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF SECRETARY

Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

In the Matter of	)	
	)	
Federal-State Joint Board on	)	CC Docket No. 96-45
Universal Service	)	

REPLY COMMENTS OF TDS TELECOMMUNICATIONS CORPORATION

AND CENTURY TELEPHONE ENTERPRISES, INC.

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January 10, 1997

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REPLY COMMENTS OF TDS TELECOMMUNICATIONS CORPORATION AND CENTURY TELEPHONE ENTERPRISES, INC.

TDS Telecommunications Corporation (TDS) and Century Telephone Enterprises, Inc. (Century), by their attorneys and on behalf of their 141 incumbent local exchange carriers (ILECs), submit these reply comments in response to comments filed in the above-captioned proceeding with regard to the Joint Board's Recommended Decision.[1] All of our ILECs qualify under the statutory definition of "rural telephone company" and have long been the carriers of last resort for their service areas. We shall confine our reply to a few points here and continue to rely on the detailed discussion of other issues in our opening comments. We plan to continue to pursue results in this proceeding and over the next three years that ensure the ultimate high cost mechanism adopted for rural areas delivers the telecommunications and information resources Congress intended for our rural customers.

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[1]Federal-State Joint Board on Universal Service, FCC 96J-3, Recommended Decision, CC Docket No. 96-45 (released Nov. 8, 1996) (RD).

Summary

The comments reflect great confusion and controversy about the many crucial issues the Commission must resolve (a) in the dwindling time before its May decision deadline and (b) in its subsequent proceeding to tailor an appropriate rural LEC proxy and high cost support plan. It must obtain the factual input necessary to make statutorily-required conclusions that the resulting support will be "specific," "predictable," "explicit" and "sufficient" to achieve "just, reasonable and affordable rates," "reasonably comparable" rural and urban rates and services, nationwide access to advanced telecommunication and information services and an "equitable and nondiscriminatory" carrier contribution system. Concrete facts and comment on a clearly defined proposal are essential to provide a sustainable factual predicate for the result-oriented statutory conclusions.

The proposed carrier contribution scheme is not competitively neutral or "equitable and nondiscriminatory" as the law demands. It would be hard to fashion a competitively neutral and economically sound value-added approach from the proposed levy on gross revenues net of payments to other carriers because of the current bars, placed only on incumbent LECs, to passing levies through to <u>all</u> their customers. The Commission would have to permit proportional recovery in charges to carriers for unbundled elements and to prevent state regulators from impeding flexible recovery of a fair share in end user rates. The best solution to achieve neutral and economically sound results is to base carrier contributions on retail revenues (<u>i.e.</u> without netting out intermediate carrier to carrier payments or levying on support revenues) and to collect a proportionate surcharge on all end user (<u>i.e.</u> retail) bills. Expert analysis in Attachment A supports this

conclusion.

Comments demonstrate that limiting support to a first, primary residence connection and (at a reduced level) a single line business connection conflicts with the Act's mandate for "reasonably comparable" rural and urban rates and services and will adversely affect rural economies, institutions, businesses and households. Congress did not authorize regulators to decide what rural rates and services should be comparable. If additional lines must pay full costs under traditional pricing, the lost support and decreased demand will undercut rural improvements and obstruct rural access to the information marketplace. Repricing additional lines incrementally to reflect the economic fact that the first line incurs most of the cost would require more support and/ or rate increases in the first lines and single business connections the Joint Board deems worthy of support.

The record proves that the proposed nationwide average revenues benchmark compares mismatched terms in many respects and cannot rationally identify what support level will satisfy the Act's pragmatic "sufficiency" and goal achievement standards. Actual costs or a rate comparison that reflects different rural scope of service and market characteristics should be the foundation for a lawful benchmark to calculate support.

The Commission should adhere to the Act's clear directives and principles by (1) rigourously testing and pricing out firm proposals to weigh their impact under the statutory results-based tests, (2) replacing the faulty proposed hybrid "value -added" contribution scheme — that seriously disadvantages only incumbents because they alone are typically subject to regulation of charges to other carriers and end users — with an economically sound levy on retail revenues, collected through an explicit surcharge on end user bills, (3) substituting an actual cost or appropriate rate benchmark that reflects rural differences in place of the well-intended but seriously flawed nationwide revenues benchmark and (4) restoring support to all high cost rural connections to avert increases in rates and support costs.

The Comments Thus Far Underline the Crucial Need for Careful Analysis of How Specific, Detailed Proposals Measure Up to the Statutory Universal Service Directives

In our opening comments, TDS and Century urged the Commission to obtain detailed impact information on clearly defined proposals for a high cost mechanism, both (a) in the workshops to develop a proxy for non-rural LECs and (b) in the further proceeding the Joint Board wisely realized would be necessary to tailor a plan able to accommodate rural differences and rural LECs' vulnerability to harm from ill-advised or overly hasty changes in federal universal service support. Review of the positions taken in opening comments reveals that there remains great uncertainty about the impact — and even the meaning — of the preliminary outlines of a high cost recovery plan sketched by the Joint Board's recommendation.[2]

The "unknowns" begin, of course, with the Joint Board's candid admission that no adequate proxy model has yet been found to determine the costs of universal service from which the Commission can determine the necessary amount and distribution of high cost compensation for each eligible telecommunications carrier (ETC). Added to that open question are disputes about virtually every facet of the Joint Board recommendations.

[2]Citations herein to parties' December 19, 1996 comments on the Joint Board recommendation will provide the filing party's name, abbreviation or acronym and the referenced page.

Until the many disputes can be resolved and the impacts of specific terms can be measured, the Commission and parties are simply unable to apply the result-oriented universal service blueprint, enacted by Congress in the Telecommunications Act of 1996,[3] to proposed high cost relief measures. TDS and Century, therefore, must again emphasize the critical importance of allowing thorough impact analysis of a particularized proposal before its adoption. Without knowing the impacts on all universal service providers, and especially on rural LECs, the Commission will necessarily remain unable to complete its implementation task. To do that, it must conclude that its new high cost recovery mechanism will provide support that is "predictable," "specific" and, above all, "sufficient...to achieve the purposes of [the Act's universal service] section." These mandated statutory purposes include "just, reasonable and affordable rates," "reasonably comparable" rural and urban rates and services, nationwide access to "advanced telecommunications and information services" and "equitable and nondiscriminatory contribution" towards the costs of universal service by "[a]ll providers of telecommunications services." The record abounds with examples of how the RD conflicts with these explicit statutory results the plan is required to achieve.[4] The Commission cannot rationally hold that a universal service mechanism satisfies the statute until it obtains enough concrete information to provide the missing factual predicate for such a conclusion.

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[3]P.L. No. 104-104, 110 Stat.56 (1996 Act), codified in the Communications Act of 1934 (the Act), 47 U.S.C. §§151 et seq.

[4]See, e.g., Rural Telephone Coalition (RTC), passim; Pacific Telesis at 3-5; USTA at 29; California Small Business Association (SBA) at 6-10.

The Joint Board's Proposed Carrier Contribution Scheme Conflicts with the 1996 Act, the Joint Board's Competitive Neutrality Principle and Economic Theory

The Joint Board proposes to base carrier contributions on revenues net of payments to other carriers, without providing what Nynex explains (p. 11) and the Vermont PSC confirms (pp.10-11) is the necessary opportunity to recover those costs. TDS and Century explained in their comments (pp. 8-13) that the Joint Board's recommendation for calculating carriers' contribution responsibilities toward the federal universal service program is neither economically sound nor competitively neutral, let alone "equitable" and "nondiscriminatory." The RD has combined two economically legitimate ways to levy support contributions. Its hybrid scheme fails to achieve the economic purposes of either of the economically sanctioned methods. The statement of Professors Panzar and Wildman at Attachment A to this reply provides more complete economic analysis of why the proposal needs rethinking and modification to achieve the economic and non-distorting result the Joint Board intends.

As explained in the Attachment, the proposal cannot claim the competitive neutrality of a true "value-added" method — which the Joint Board thought it was applying by allowing carriers to deduct their payments to other carriers from their revenues to avoid double recovery — because the ILECs are not allowed to pass their contributions on to <u>all</u> of their customers. The RD states (¶808) that purchasers of unbundled elements from ILECs must not be charged for any share of the ILEC's contribution.[5] Beyond that, as the analysis attached to Ameritech's comments

[5]The statement that universal service contributions can be recovered by a carrier from a "user" is confusing, but seems to leave the ILEC providing an unbundled element without the right to pass a share of its contribution through in its wholesale charges.

explains (pp. 27-28), ILECs alone of the carriers that must contribute are typically subject to state regulation that prevents them (but not their competitors) from freely recovering a share of their universal service contribution from their end user customers.

AT&T (pp. 8-9) and the RTC (pp. 35-36) agree, stating that competitive neutrality requires permitting carriers to recover their contribution proportionally from all services and customers. Indeed, AT&T urges the Commission to require that such recovery be explicit to prevent strategic allocation of a carrier's contribution cost to the disadvantage of its consumers and competitors. The RTC, too, cautions (pp. 35-36) that the net revenues approach will create undesirable incentives to recoup all or an unfair share of their contributions from end users without choices. A number of comments (e.g., Nynex at 18) address this same ILEC competitive obstacle under the Joint Board's proposal by their support for basing carrier contribution on "retail revenues." Comments that support the net revenues measurement have ignored the disadvantage ILECs will suffer from impediments to passing the contribution costs through to customers flexibly and equitably. As Professors Panzar and Wildman demonstrate (Appendix A) and Cincinnati Bell illustrates (pp. 9-10) the result is an unfair competitive handicap against ILECs.

It would be possible, but difficult, for the Commission to rectify the problem of ILECs' inability to recover their contributions from all classes of customers, while maintaining a net revenues approach -- or in other words to remedy the Joint Board's attempt to establish an equitable and nondiscriminatory "value added" levy. But it would require some rather fundamental and politically sensitive modifications to render the net revenues measure economically correct: Even if the Commission wisely abandons its distortive prohibition on passing through carriers' universal service contributions in their charges for unbundled elements, it must still find a way to prevent states from rejecting ILEC rate (or price cap) increases designed to pass a fair share of the contribution through to consumers, consistent with sound economic practice.

Therefore, the best proposal for achieving economic orthodoxy and fairness for all carriers and customers is (a) to modify the contribution mechanism to use a "downstream" retail revenues levy method and (b) to recover the contribution equitably from all customers by means of a surcharge based on each customer's retail purchases of telecommunications services. Like TDS and Century (pp. 8-14), AT&T (pp. 8-9), USTA (pp. 22-23) and others urge the Commission to require carriers to recover federal universal service contribution costs — calculated on their gross retail revenues from customers, without netting out payments to other carriers or levying on revenues from universal service mechanisms — by collecting such a proportional retail surcharge.[6]

In contrast, some comments embrace the Joint Board's legal rationale for rejecting customer surcharges, claiming that the law limits contributions to carriers (TURN at 8-9), while others seem simply to like the result of the net revenues method (e.g. GCI at 5-9, TCG at 11-12). However, the more rational view (e.g. Worldcom at 40-41) is that a surcharge on retail customers

[6]Professors Panzar and Wildman demonstrate in Appendix A (pp. 5-6) that including universal service as "revenues" for calculating carrier contributions would divert a portion from its intended support function. The retail surcharge method avoids both violating the mandate in §254(e) that support must only be used for the "provision, maintenance, and upgrading of facilities and services for which the support is intended," and the adjustments that would be necessary to end up with "sufficient," actually available, high cost support. See, also, SNET at 3-4.

is the preferable way to satisfy the statutory requirement in section 254(e) for "explicit" federal support. In addition, comments point out that a surcharge on all retail customers would be lawful (e.g. LCI at 13-14), would let customers know what they are contributing towards universal service (e.g. California Department of Consumer Affairs (CDCA) at 19, 39-40), would be fair and easy to administer (AT&T at 9), would be economically sound (see Appendix A at 2-3), as well as being lawfully "explicit" (e.g., USTA at 22-23) and competitively neutral (e.g., California PUC at 13-15).

In short, CDCA has it right (p. 38): "Amazingly, the resolution of this complex problem is simple." The Commission should accept the economic and policy justifications that satisfy the Act's requirements for (a) nondiscriminatory and equitable carrier contributions, (b) equitable responsibilities for all customers, and (c) "explicit" support: It should measure carrier contributions by retail revenues and collect end users' share of universal service support via a surcharge on their bills for retail service.

The Commission Should Not Deny Universal Service Support to Customers or Connections It Thinks Congress Should Have Excluded

The comments on limiting eligibility for universal service support reflect many views. There are those that oppose the proposal to exclude all but a single primary residence connection and to provide a reduced level of universal service support restricted to a single line business connection. There are others that support the proposal or even urge draconian exclusion of all business connections from the mechanisms mandated by section 254. The U.S. Small Business Administration (pp. 1-3) cogently criticizes the proposal to reduce or eliminate support for business connections in high cost rural areas as unprecedented, unauthorized by the 1996 Act, and prejudicial to rural business and local institutional subscribers. It specifically identifies the adverse effects on "town halls, police stations, churches, local school boards, nursing homes, doctors' offices, fire stations, etc." (Id. at 2). RT Communications (pp. 10-11) expresses concern that the withdrawal of high cost support will interfere with the engineering, efficiency and availability of facilities upgrades. Silver Star points out (p.4) that it will have to double its rates for second residences from current $22 levels. The Western Alliance also warns (pp. 15-17) that narrowing eligibility will raise rates and prevent "reasonably comparable" rates for the excluded lines in rural and urban areas. It criticizes the implicit assumption that multiline businesses are large companies that can withstand rate increases. It also reports (pp. 22-23) that one member ILEC will have to raise all residential and business service rates by 60 % or raise multiline business rates by 130%.

TDS and Century observed (p. 23-31) that the impact on second and additional lines would be diminished if additional connections were properly priced to recover their low incremental costs. However, the result of changing the long-established practice of averaging local rates for all lines would be to increase the rates for all primary residence lines and single line businesses to their true economic cost -- unless added support per line is made available for the first, principal cost-causing installations. The proposal could thus adversely affect the customers the Joint Board considers most worthy of support.

Roseville Telephone explains (pp. 6-9) that the exclusion will be extremely difficult to administer. TCA (pp. 5-6) agrees and warns that monitoring will be troublesome. TCA goes on to explain that limiting support conflicts with the principle of fostering access to advanced services because second lines are often the key to using the Internet, faxes, modems and other " 'information highway' tools." JSI adds (pp. 20-22) that the exclusion will disrupt the market and lead to arbitrage.

Those that urge elimination of support for all business service (e.g. Sprint, p. 14, Ameritech, p. 7) assume that any business should absorb the full cost of service -- even in the highest cost location. For example, TCG offers the bare assertion (p.3) that businesses, "no matter what size" are better able to pay full cost than residential customers. These opponents of fully comparable rural and urban business rates and services do not discuss the impact on rural economic development or the revenues available to support infrastructure upgrades if even a significant fraction of the lines that now contribute towards high rural service costs are disconnected. This is particularly so when it is recognized that additional lines are now generally contributing more than their incremental costs because of today's rate structure.

There is no factual support in the record for a presumption that the effect on the statutory universal service standards from eliminating support for the excluded lines will be negligible. And none of the supporting comments has suggested any statutory basis for the Joint Board's abrupt departure from long-time national policy to brand some types of high cost rural connections as unworthy of support. The Commission should reject the unlawful recommendation and, as Harris, Skrivan and Associates urges (p.7), restore universal service eligibility to all rural access lines.

The Proposed Nationwide Average Revenues Benchmark Cannot Be Justified under the Act's Universal Service Standards

TDS and Century showed in their opening comments (pp. 30-37) that the recommended high cost benchmark based on revenues for local, access and discretionary services is inappropriate because (a) it compares past revenues to forward-looking costs, (b) it ignores differences in rural and urban revenues and services, (c) it ignores the Joint Board's own finding, with regard to affordability, that rural customers must make toll calls for communications that are within the local rate in urban areas, and (d) it will be costly and difficult to develop separate revenue benchmarks for single line businesses and first primary residence connections because that information is not available and cannot readily be obtained.

Numerous comments elaborate on further faulty comparisons inherent in the benchmark. For example, Cincinnati Bell (pp. 8-9) and Pacific Telesis (pp. 16-17) explain that the benchmark compares revenues for discretionary and access services that are not included in the universal service costs that proxy models are meant to identify. In contrast, Time Warner (pp.19, 21-23) faults the revenues benchmark for excluding yellow page and imputed toll access revenues. The RTC adds (pp.23-24) that the comparison between actual historical results and hypothetical future costs is particularly inapposite. The RUS cautions (pp. 2-3) that the measurement will be dominated by urban revenues and is likely to place undue support burdens on certain rural states. In contrast, Sprint proposes (p.18) a benchmark based on nationwide urban rates. And Time Warner points out (p.14) that the nationwide revenues benchmark is ill-matched to the highly disaggregated cost breakdown sought by the proxy models, which separates rural and urban cost characteristics. USTA (pp. 9-11) believes the revenues benchmark compares the wrong factors, suggesting instead that the costs of universal service should be subtracted from the revenues for the same services, with affordability components for business and residential service based on county income data. In addition, Alltel is concerned (p. 9) that the revenues benchmark invites manipulation to reduce support by overestimating the revenues a LEC can expect from its customers.

Some parties, like Time Warner, (pp. 14-18) apparently think the proposed benchmark can be modified to serve the purpose of measuring high cost support. Others, such as MFS (pp. 22-26), try to solve the problem of comparing theoretical proxy costs to actual historical revenues by suggesting a wholly-theoretical comparison between individual company proxy costs and nationwide average proxy costs (i.e. costs reaggregated after the fictional proxy model estimates them based on data for numerous geographic subdivisions).

The views on the proposed benchmark are diverse. However, the bottom line is that no comments have shown how the information developed by the proposed nationwide revenues benchmark can possibly support a principled determination that the resulting mechanism will provide the legally required "specific," "predictable" and "sufficient" support at a level that will achieve "just, reasonable and affordable rates," access to advanced and information services and "reasonably comparable" rural and urban rates and services. The many and serious flaws disclosed in the record indicate that the average revenues mechanism is not capable of supporting the statutory conclusions. Consequently, the Commission should turn its attention to developing a benchmark based on actual cost comparisons or a rate factor that properly reflects rural calling and cost recovery differences.

Conclusion

The record reveals that, with the May deadline for implementing section 254 relentlessly approaching, the Commission has before it the task of resolving almost all the issues raised in this proceeding but not resolved by the Joint Board. The workshops should help in advancing the search for a cost proxy. Workshops will only advance the Commission towards lawful implementation of the result-oriented Act, however, if (a) the express statutory criteria for support, rates, services and infrastructure development are made the focal point for evaluating proxy alternatives and (b) the Commission gathers sufficient information on a specific proposal to quantify the results and apply the statutory standards to concrete facts. The same careful attention to the will of Congress is essential for (a) developing an economically sound, competitively neutral, "nondiscriminatory" and "equitable" carrier contribution and recovery method, (b) replacing the fatally faulty average revenues benchmark proposal with a practical and pertinent cost or rate comparison that will generate high cost support consistent with the Act, (c) restoring eligibility for support to lines and services that have been arbitrarily eliminated on the basis of value judgments inconsistent with the Act, to achieve illusory savings in total support and (d) repairing or replacing other shortcomings of the RD revealed by the record so far and the Commission's ongoing investigations.

Respectfully submitted,

TDS TELECOMMUNICATIONS CORPORATION

and

CENTURY TELEPHONE ENTERPRISES, INC.

By /s/ Margot Smiley Humphrey
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January 10, 1997

Comments on the Joint Board Recommendations for Funding Universal Service

by

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January 9, 1997

Introduction and Summary

The Joint Board's recommendations for raising revenues required to cover the costs of providing Universal Service are seriously flawed. As presented, the plan is not competitively neutral. Since this is contrary to both the provisions of the Telecommunications Act of 1996 and the Joint Board's stated intent, the current plan must be revised. In addition, we recommend that support payments received by ILECs should not be subject to any fund contribution levy imposed on ILEC revenues.

What is the appropriate base for Universal Service levies?

The focus in the public policy debate on Universal Service funding has been on "competitive neutrality," i.e., ensuring that no carrier or class of carriers experiences a competitive disadvantage as a result of the funding mechanism employed. However, there are also important additional economic efficiency issues to be considered. Any levy placed on the sales of telecommunications services will tend to cause customers to substitute away from such services in attempting to meet their information and communications needs.

Even individual consumers have this option available to them to some extent. For example, they can reduce their minutes of use by purchasing faster modems and more sophisticated software. This substitution is in addition to the general tendency to spend the less of the family budget on items which become more expensive. Thus even a levy based entirely on the sales of telecommunications services to final consumers will result in some distortion of economic choices. This is inevitable if the required Universal Service funds are to be raised.

However, levies placed on the sales of intermediate (wholesale) telecommunications services also unnecessarily distort choices in the production of final products and services utilizing those services as inputs. There are two ways to avoid this type of distortion: (1) The "retail levy," or surcharge on retail rates, which places the levy on retail sales but not on wholesale transactions; and (2) The "value-added levy," which places a percentage levy on all industry transactions, but allows carriers to: (a) deduct payments to other carriers from this revenue base; and (b) pass through levies in the wholesale prices charged to other carriers and in prices to end users.

Unfortunately, the Joint Board recommendation seems to be a variant on the value-added levy which would have the effect of undermining competitive neutrality. To see this, consider an ILEC offering local service in competition with an IXC which purchased unbundled loops from it. All the local service revenues of the ILEC would be subject to the levy, but the IXC would be able to deduct the costs of its rented loops from its local service revenues before applying the levy. This would give the IXC an artificial competitive advantage in the local service market.

A simple numerical example will help clarify this point further. Consider the following hypothetical situation: The ILEC incurs loop costs of $20 per customer and switching costs of $7 per customer. The IXC also would incur switching costs of $7 per customer if it offered retail local exchange service. The IXC can purchased unbundled loops from the ILEC at cost.[1] Finally, the Universal Service levy is 10%.

First note that a common percentage levy on retail sales of all carriers is, in fact, competitively neutral. By this we mean that imposing the levy leaves equally efficient carriers equally positioned in the competitive market in question. Here, the local exchange market. Obviously a common levy on retail sales fulfills this definition. In the example, the lowest rate the ILEC could charge to cover its costs would be $30. This revenue per customer would be expended as follows: a payment into the Universal Service fund of $3 = (.10)($30); $7 in switching cost; and $20 in loop costs. An equally efficient IXC could also just cover its costs offering local service at a rate of $30. This revenue per customer would be expended on $3 = (.10)($30) in Universal Service fund payments, $7 in switching costs, and $20 in loop rentals paid to the incumbent ILEC. Total Universal Service payments would remain unchanged at $3 because, under the retail levy scheme, the wholesale receipts of the ILEC for loop rental are not subject to the levy. Clearly, under this funding mechanism, an IXC would be able to successfully match or undercut the ILEC if and only if it was equally or more efficient in providing switching services.

Under the Joint Board recommendation, the lowest price the ILEC could charge for local service would also be $30. Of this revenue, $3 = (.10)($30) is the ILEC's payment to the Universal Service fund, $7 covers its switching costs, and $20 its loop costs. The ILEC just breaks even. Now consider the prospects of an IXC which entered the local exchange market by purchasing unbundled loops from the ILEC and supplied switching services itself. Suppose it undercut the ILEC by offering a rate of $29, how would it fare? One interpretation of the Joint Board recommendation is that the IXC could deduct its

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[1] We emphasize that we are *not* recommending that unbundled network elements should be priced at incremental cost or that incremental cost pricing of such elements is in any sense required for competitive neutrality. We make that assumption here only for analytical simplicity.

payments to the ILEC before applying the Universal Service levy, but the ILEC could not increase its rental rate to reflect its Universal Service fund liability.[2] Its Universal Service fund contribution would be only $.90 = (.10)[$29-$20]. At a price of $29, the IXC would earn a per customer net profit of $1.10 = ($29 revenue) - ($.90 US charge) - ($7 switching cost) - ($20 loop rental). The IXC could profitably undercut the ILEC's break-even rate, even though it was no more efficient.

More seriously, under the Joint Board recommendation, the IXC could successfully undercut the ILEC even if it were *less efficient.* To see this, suppose that the IXC's switching costs were $8 per customer in the above example. Then its per customer net profit would remain positive at $.10 at a rate lower than that at which the more efficient ILEC could cover its costs. Of course, the ILEC could meet this challenge by establishing a separate subsidiary. But, the Universal Service funding mechanism should not induce possible wasteful restructuring in and of itself.

However, as discussed above, it is possible to design a competitively neutral funding scheme that employs a common levy on wholesale and retail transactions as long

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[2] "The Joint Board, acknowledging GTE's comments that some ILECs may not be free to adjust rates to account for the amount of their contributions to universal service support, recommends clarifying that, under the Commission's section 251 rules, ILECs are prohibited from incorporating universal service support into rates for unbundled network elements. We note, however, that carriers are permitted under section 254 to pass through to users of unbundled elements an equitable and nondiscriminatory portion of their universal service obligation." Recommended Decision, paragraph 808. Our interpretation and analysis of the Joint Board's Recommended Decision is based on the first sentence of this rather confusing paragraph, which appears to prohibit contribution to Universal Service support in the prices of unbundled network elements. However, the second sentence seems to raise the possibility of a pass through of an "equitable and nondiscriminatory" portion of the ILEC's obligation to users of unbundled network elements. Who such users might be and whether they incur Universal Service obligations of their own is not clear. In the event that the second sentence is operative, either of the two competitively neutral value-added approaches described in this paper might be used to design "equitable and nondiscriminatory" pass through rules.

as payments to other carriers *and wholesale prices are allowed to reflect the levy.* In the context of our example, we have seen that the lowest rate at which an ILEC could profitably offer local exchange service is $30. Now consider the lowest profitable rate which could be offered by an equally efficient IXC renting unbundled loops. Competitive neutrality requires that this price also equals exactly $30. Let us examine the fate of an IXC which quotes a price of $30 for local exchange service. To determine the per customer base for the Universal Service levy, we must deduct the amount it pays to the ILEC for loop rental. Since the wholesale loop rental transaction is also subject to the 10% levy, the transaction price is $22.22, which covers the ILEC's per subscriber Universal Service fund payment of $2.22 and its per subscriber loop costs of $20. Thus the IXC's per subscriber Universal Service fund payment is $.78= (.10)[$30-$22.22]. This, combined with its switching costs of $7 per customer and loop rental of $22.22 per customer exactly equals its rate of $30. Notice that total Universal Service funding remains unchanged at $3 = $.78 (from IXC) + $2.22 (from ILEC).

If the IXC were less efficient than the ILEC at providing switching, similar calculations would reveal that it could not earn a profit at a $30 local exchange rate, while it would earn positive profit if it were more efficient. (The IXC *loss* with an $8 per customer switching cost would be $1, its *profit* with a $6 per customer switching cost would be $1.) Thus, as competitive neutrality requires, the uniform wholesale and retail levy with deductibility would allow entry to be successful if and only if the entrant were at least as efficient as the ILEC, and would allow the ILEC to be successful in the sale of retail services only if it were at least as efficient as the IXC and other entrants.

As our example illustrates, the key difference between the Joint Board recommendation and a competitively neutral funding mechanism is that the former does not allow wholesale levies to be reflected in the market price. If wholesale prices were determined in a competitive marketplace, this pass-through would happen automatically. However, if wholesale rates are regulated, Universal Service fund payments must be recognized as costs to be recovered if competitive neutrality is to be achieved. Similarly, if retail rates are regulated, ILECs must have the same flexibility as their competitors to reflect Universal Service contribution in their retail rates.

Support payments should not be included in the revenue base when computing Universal Service contributions

The Joint Board recommendation seems to include support payments in the ILEC revenue base to which the Universal Service levy would be applied. Obviously, this policy would reduce the amount of net support a high cost ILEC would receive from any given per subscriber support payment and unnecessarily complicate support and payment calculations.

The above example can be extended to demonstrate that Universal Service support payments received by ILECs should not be subject to the levy if maximum rate relief is to be obtained from a given level of support payment. Suppose an ILEC received support payments of $9 per subscriber because it served a high cost area with loop costs of $29. If these payments were *not* included in the revenue base, the lowest rate it could charge would be reduced to $30. The ILEC's total per customer receipts of $39 = $30 + $9 would exactly equal its Universal Service fund levy of $3 = (.10)($30) plus its costs of $36. However, if these payments were included in the base to which the 10% levy was applied, the lowest rate the ILEC could charge and still break-even would be $31. To see this, note that, for each subscriber, the ILEC would pay a Universal Service fund levy of $4 = (.10)[$31 +$9] and incur costs of $36 = $29 + $7. These payments and costs of $36 would exactly equal the ILEC's receipts of $9 in support and $31 in revenue. Thus the rate relief available to high cost area subscribers would be significantly reduced.

CERTIFICATE OF SERVICE

I, Weldrena Jones-Bean, do certify that on this 10th day of January, 1997, a true and correct copy of the foregoing "Reply Comments of TDS and Century Telephone Enterprises, Inc." was served by United States First Class Mail, postage prepaid, upon the persons named on the attached service list.

/s/ Weldrena Jones-Bean
Weldrena Jones-Bean